March 12, 2014

VIA EMAIL: rule-comments@sec.gov

Elizabeth M. Murphy,
Secretary
U.S. Securities & Exchange Commission
100 F Street NE
Washington DC 20549-1090

Re: SR-FINRA-2014-006 Proposed Rule Change to NASD Rule 2340 (Estimated Values of Unlisted Direct Participation Programs (DPPs) and REITs on Customer Account Statements)

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association[1] ("SIFMA") Clearing Firms Committee ("CFC") is pleased to have the opportunity to comment on FINRA's proposed rule change to NASD Rule 2340 involving per share estimated values of unlisted Direct Participation Programs (DPPs) and Real Estate Investment Trust (REITs)[2] on customer account statements (the "Proposed Rule Change"). Rule 2340 "applies to members that self-clear or clear for other members." (*See NASD NTM 01-08*). The SIFMA Clearing Firms Committee is well positioned to comment on the Proposed Rule Change because it represents the interests of fully-disclosed clearing firms that clear and settle millions of securities transactions each day for thousands of introducing broker-dealer firms.

[1] The Securities Industry and Financial Markets Association is a non-profit industry association that represents the shared interests of participants in the global financial markets. SIFMA members include more than 600 international securities firms, U.S.-registered broker-dealers, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. More information about SIFMA and its members and activities is available on its website www.sifma.org.
[2] Unlisted DPPs (including LLCs and LLPs) and REITs do not trade on a national securities exchange. (See NASD NTM 01-08 (adopting amendments to NASD Rule 2340 effective 4/16/01)).

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SIFMA is submitting this Comment Letter as a follow-on comment to SIFMA's November 10, 2011 comment letter, which was filed in response to FINRA's first set of proposed amendments to NASD Rule 2340 issued through Regulatory Notice 11-44 (hereinafter "2011 SIFMA CFC Comment Letter"). The 2011 SIFMA CFC Comment Letter is attached as **Exhibit A** to this filing for reference.

The 2011 SIFMA CFC Comment Letter objected to, among other things, imposing an affirmative duty on clearing firms to monitor and confirm the reliability of estimated values under a proposed new requirement that the clearing firm must refrain from using the value if it "had reason to know" that the value was unreliable. (The current standard in Rule 2340 as enacted since 2000 is that a clearing firm must refrain from using an estimated value if it can "demonstrate" that the estimated value is "inaccurate.").

In response to comments, FINRA withdrew that part of the proposed amendment and replaced it instead with a more reasonable proposed standard through Regulatory Notice 12-14, issued in March 2012. Under Regulatory Notice 12-14, a clearing firm would not be required to include an estimated value on an account statement that "it reasonably believes is unreliable."

SIFMA fully supports FINRA's efforts to design rules intended to improve customer protection and provide greater transparency in this area – such as the Proposed Rule Change's acceptance of two types of valuation methodologies (net investment or independent valuation) as creating a "presumption" that the valuation(s) "have been developed in a manner reasonably designed to ensure that it is reliable." However, SIFMA is concerned primarily with two main issues raised by the Proposed Rule Change:

1. Because the Proposed Rule Change creates a presumption of reliability for net investment or independent valuation methodologies which apparently may be rebutted by other facts (see Proposed Rule Change at p. 7, n. 9), it is imperative that the actual text of the rule as proposed be corrected to reflect the "reasonably believe is reliable" standard for a clearing firm in relying on the estimated valuation it receives in order to post the valuation on an account statement – as opposed to the current formulation – that the clearing firm "ha[ve] no reason to believe the per share estimated value is unreliable." The language contained in the text of the proposed Rule Change erroneously seeks to impose an absolute "no reason to believe is unreliable" standard upon clearing firms. SIFMA submits that this "no reason to believe" standard has been proposed in error because:

    a. It is inconsistent with the Proposed Rule Change's own lengthy commentary which repeatedly uses the phrase "reasonably believes" – not "no reason to believe." The two terms are not synonymous nor are they interchangeable. As further set forth below, SIFMA submits that the "reasonably believes" standard properly reflects FINRA's actual intent in connection with this Proposed Rule Change.

b. A "no reason to believe is unreliable" standard is just as unworkable as the proposed "had reason to know" standard – previously rejected by FINRA in Regulatory Notice 12-14. An absolute "no reason to believe" standard would mean that a clearing firm would be required to continuously monitor the "reliability" of estimated pricing received for millions of introduced accounts to determine if it had "no reason to believe" the information was unreliable. Such a standard transforms a clearing firm into a guarantor or insurer of estimated valuations (even if received via a net investment or independent valuation methodology) – which is well beyond the scope of responsibility normally allocated to a clearing firm – especially given its limited back office role for clearance and settlement for millions of securities transactions each day. If clearing firms were required to continuously monitor the "reliability" of estimated pricing received for millions of introduced accounts to determine if it had "no reason to believe" the valuations were unreliable, it would create an unduly burdensome process and a significant drain on available resources.

c. In 2000, one of FINRA's predecessor firms, the NASD, amended its proposed changes to Rule 2340 (NASD 00-13 Amendment No. 1) to remove as unworkable the exact same "no reason to believe" language. In the 2001 Notice to Members accompanying the Rule change (*NASD NTM 01-08*), the NASD further stated that Rule 2340 was "not intended to impose an obligation on members to confirm the accuracy of an estimated value obtained from a third party source."

2. The Proposed Rule Change still fails to address the Rule's potential conflict with the obligation for a custodian or trustee of individual retirement accounts ("IRAs") to provide fair market value ("FMV") information to end-customers and the Internal Revenue Service ("IRS") on IRS Form 5498 (*IRA Contribution Information*), which requires the inclusion of an annual FMV for every security – including DPPs and REITS – held in IRAs. Thus, the Proposed Rule Change seeking to make DPP/REIT account statement pricing "optional" would not solve the "conundrum" facing clearing firms when investors hold such securities in IRAs. In fact, the Rule may result in the undesirable outcome of forcing a broker-dealer's affiliate or non-affiliate IRA custodian or trustee, to no long support DPPs and REITS in IRAs or even resign as custodian or trustee of certain IRAs if the broker-dealer chooses not to display an estimated per share value for a particular DPP or REIT on a monthly account statement. Such a result is not beneficial to the end-customer and could not be what FINRA intended in seeking to improve customer protection and provide greater transparency in pricing for such illiquid securities.

I. The Text of the Proposed Rule Change Needs to Be Corrected to Impose the Proper "Reasonable Belief" Standard

A. The "Reasonable Belief" Standard is Used Throughout the Commentary to the Proposed Rule Change and Should Be Reflected Verbatim in the Rule Text.

SIFMA believes that the "reasonable belief" standard properly reflects FINRA's actual intent because the "reasonable belief" standard (rather than the "no reason to believe" language) is used repeatedly by FINRA in its lengthy commentary in discussing the Proposed Rule Change:

- "A preferable approach is to require that any valuation that is included in a customer account statement has been developed in a manner reasonably designed to ensure that is reliable, and to prohibit a member from including any valuation that it has reason to believe is unreliable." (*Proposed Rule Change at p. 12*) (underscore supplied)

- "Under the proposal, a methodology developed in a manner reasonably designed to ensure that it is reliable may be used (unless the member has reason to believe that the valuation is unreliable)." (*Id. at p. 12*) (underscore supplied)

- "The proposal would prohibit a member from presenting a valuation that it has reason to believe is unreliable." (*Id. at p. 13*) (underscore supplied)

- "If presentation of a valuation were optional, then the rule would not deter the member from following up on red flags and excluding a valuation that it has reason to believe is unreliable." (*Id. at 13*) (underscore supplied)

Accordingly, the text of the Proposed Rule Change should conform to the language of the commentary explaining it. The text of the Proposed Rule Change should therefore state that a clearing firm can post an estimated value for a DPP/REIT on an account statement "unless it reasonably believes that such estimated value is unreliable."

B. **The 2011 SIFMA CFC Comment Letter Objections Apply Equally to the "Has No Reason to Believe" Standard**

In 2011, the SIFMA Clearing Firms Committee submitted a Comment Letter which, in part, addressed the then proposed requirement that a clearing firm must refrain from using valuation information if it "had reason to know" that the value was unreliable. SIFMA explained in great detail the precedent and regulatory history of the specialized and limited role of the clearing firm and why such a proposed knowledge standard would be unworkable for the industry. Those same arguments apply with equal force today with respect to the absolute "no reason to believe" standard set forth in the text of the Proposed Rule Change.

As noted above, the broad language of the Proposed Rule Change would in essence require the clearing firm to act as an insurer or guarantor of estimated valuations received from third parties who have far more expertise in providing valuations – or face regulatory exposure and potential civil liability after the fact. Clearing firms handle hundreds of thousands of trades daily on behalf of millions of end customers of introducing firms. Clearing firms send out millions of monthly account statements to end customers. Clearing firms lack the expertise or the operational resources to be able to confirm the reliability of estimated valuations received from others (many of whom are in the very business of providing such valuations). As the valuations appear on monthly (or, if applicable, quarterly) statements, it would impose an incredible burden on the clearing firm to perform an investigation and monitoring review into each of the thousands of unlisted DPPs and REITs held by end customers prior to transmitting each monthly (or quarterly) account statement. Such a standard would inappropriately shift the burden of providing accurate pricing information to the investor from the issuer of the investment to the clearing firm.

SIFMA previously argued that FINRA – by imposing a standard that is based on whether the member "has reason to know" – would be codifying an affirmative duty of inquiry upon the clearing firm that is inconsistent with the specialized role of the clearing firm as has been recognized by courts and regulators for decades. The vague phrasing of "no reason to believe" would impose a similar duty of inquiry, as a clearing firm would have to prove a negative by conducting a fulsome and extensive investigation each month prior to displaying a price. In effect, by proposing this standard, FINRA is stating that no valuation provided by a third-party source can ever be accepted on its face. As such, it eliminates any of the efficiencies that arise from using a third-party expert to obtain and/or provide such valuations. SIFMA respectfully submits this could not have been FINRA's intent.

C. **NASD Has Previously Rejected the Exact Same "Has No Reason to Believe" Language When it Enacted Rule 2340 in 2000**

FINRA's own predecessor entity, the NASD, had previously rejected the "has no reason to believe" language when it first enacted Rule 2340. In 2000, the NASD submitted for public comment a draft of Rule 2340 which provided that a clearing firm could use an estimated valuation for a DPP or REIT on an account statement if "after considering any relevant information about the market and the particular investment in its possession, the member *has no reason to believe* that the estimated valuation is inaccurate." (*See* Securities Exchange Act Release No. 432601 (November 29, 2000), *65 F.R. 71169 at p. 5 n.18)* (italics supplied).

In response, Merrill Lynch submitted a comment letter objecting to that standard, stating that as then drafted, the rule "would impose an unfair obligation on a member to consider the accuracy of an estimated valuation, even if the member had obtained the estimated value from the DPP or REIT's annual report or from an independent valuation service that the member had retained to provide a valuation." *(Id. at p. 7).* NASD responded to the concerns by deleting the "no reason to believe" language and adopting the current language of the rule which states that a member may refrain from including a per share estimated value for a DPP or REIT security on an account statement only if the member can "demonstrate" that the value was "inaccurate." In so doing, NASD explicitly stated in 2000 that Rule 2340 "does not obligate a [clearing firm] to confirm the accuracy of an estimated value" for a DPP or REIT. *(Id. at p 5;see NASD NTM 01-08*).

The "no reason to believe" standard of the Proposed Rule Change is inconsistent with the NASD's own statement in 2000 that Rule 2340 was not intended to impose an obligation on members to confirm the accuracy of an estimated value obtained from a third party source. By saying that a clearing firm is permitted to post an estimated value only where it "has no reason to believe it is unreliable," FINRA is imposing an affirmative duty on Clearing Firms to monitor the reliability of the price on thousands of CUSIPs posted every month to account statements. Despite changes in technology since this proposed standard was rejected in 2000, the fact remains that to comply with such a standard remains as unworkable and unreasonable now as it was then. As the rationale behind the original rejection remains the same, the standard should similarly be rejected yet again.

II. **The Proposed Rule Change Fails to Address the Conflict With the Mandatory Pricing Requirements of IRS Form 5498 for Individual Retirement Accounts**

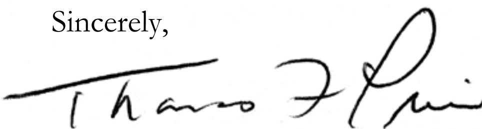
The Proposed Rule Change would also make the inclusion of DPP/REIT pricing on customer account statements optional rather than mandatory. However, the Proposed Rule Change still fails to address its potential conflict with the tax reporting requirements for IRS Form 5498 (*IRA Contribution Information*), which mandates the inclusion of an annual FMV for every security – including DPPs and REITS – held in IRAs. See 2011 SIFMA CFC Comment Letter at p. 9 & n.10

In this circumstance, the member firm's compliance with FINRA's standard would likely result in no valuation being displayed on account statements – with potentially a different valuation for IRS Form 5498 due to the difference in the IRS reporting requirements. Thus, the current wording of the Proposed Rule Change making DPP/REIT account statement pricing "optional" may require a broker-dealer's affiliate or non-affiliate IRA custodian or trustee to no long support DPPs and REITS in IRAs or even resign as IRA custodian or trustee, if the broker-dealer chooses not to display an estimated per share value for a particular DPP or REIT on a monthly account statement. Such a result is not beneficial to the end customer and could not be what FINRA intended in seeking to improve customer protection and provide greater transparency in pricing for such illiquid securities. SIFMA respectfully submits that FINRA seek to harmonize the requirements of Rule 2340 so as to avoid a conflict with the mandatory FMV requirements of IRS Form 5498.

* * *

SIFMA appreciates the opportunity to comment on the Proposed Rule Change. Our comments above are intended to reflect industry practice, and to foster consistency between the Proposed Rule Change and the regulatory guidance and well-established body of case law long governing the clearing industry. SIFMA would welcome the opportunity to discuss these comments with FINRA. If you have any questions, please reach out to me at (212) 313-1260.

Sincerely,



Thomas F. Price
Managing Director
Operations, Technology & BCP

cc: Financial Industry Regulatory Authority, Inc
Richard G. Ketchum, Chairman and Chief Executive Officer
Robert Colby, Executive Vice President and General Counsel for Regulation
Bill Wollman, Executive Vice President, Member Firm Regulation

Exhibit A

SIFMA Comment on FINRA Regulatory Notice 11-44 - Proposed Amendments to NASD Rule 2340 to Address Values of Unlisted Direct Participation Programs and Real Estate Investment Trusts in Customer Account Statements, (November 10, 2011).

November 10, 2011

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 11-44
Proposed Amendments to NASD Rule 2340 to Address Values of Unlisted Direct_Participation Programs and Real Estate Investment Trusts in Customer Account Statements

Dear Ms. Asquith:

The Securities Industry and Financial Markets Association ("SIFMA") Clearing Firms Committee[1] is pleased to have the opportunity to comment on FINRA's recently proposed amendments to NASD Rule 2340 involving per share estimated values of unlisted Direct Participation Programs (DPPs) and Real Estate Investment Trust (REITs)[2] on customer account statements (the "Proposed Amendments"). Rule 2340 "applies to members that self-clear or clear for other members." (See NASD NTM 01-08).

The SIFMA Clearing Firms Committee is well positioned to comment on the Proposed Amendments because it represents the interests of fully-disclosed clearing

[1] SIFMA is a non-profit industry association that represents the shared interests of participants in the global financial markets. SIFMA members include more than 600 international securities firms, U.S.-registered broker-dealers, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. More information about SIFMA and its members and activities is available on its website www.sifma.org.
[2] Unlisted DPPs (including LLCs and LLPs) and REITs do not trade on a national securities exchange. See FINRA Regulatory Notice 11-44 at n.1; see also NASD NTM 01-08 (adopting amendments to NASD Rule 2340 effective 4/16/01).

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firms that clear and settle millions of securities transactions each day for thousands of introducing firms.[3]

The Proposed Amendments would impose new limits on the time period the initial offering price could be used as a basis for the estimated valuation of unlisted DPPs and REITs, and would require issuers to deduct certain fees and expenses from the calculation of estimated value during the initial offering period. While SIFMA fully supports FINRA's efforts to design rules intended to improve customer protection and provide greater transparency, SIFMA is concerned the language of the Proposed Amendments may be broadly read to impose new and far-reaching obligations upon clearing firms, which are inconsistent with the clearing firms' specialized role as "back office" providers of clearing and settlement services. This role has long been recognized both under the law and in FINRA's own rules, as most recently reflected by FINRA's enactment of Rule 4311 and the continuing recognition that responsibilities respecting customer accounts may be allocated between clearing firms and introducing firms.

Specifically, SIFMA is concerned about three proposed substantive changes set forth in the Proposed Amendments:

1. A new requirement that the clearing firm "must refrain from providing a per share estimated value, *from any source*, if it knows *or has reason* *to know* the value is *unreliable*, *based upon publicly available information or nonpublic information that has come to the member's attention"*). (See Proposed Amendments at 2340c(2)(A); italics and underscore supplied).

2. A new requirement that the clearing firm must disclose the reason why an estimated valuation "does not appear in, or has been removed from, the account statement." (See Proposed Amendments at 2340c(3)(iv)).

3. A new requirement that the clearing firm must include an estimated valuation for unlisted DPPs and REITs on the account statements – even if the annual report itself contained no valuation – and even if the DPP or REIT is listed "below the line" on the account statement (in which case the clearing firm does not provide custody or clearing services for the position on behalf of the

[3] Because many introducing firms (aka "correspondents") do not have the net capital, resources, technology, personnel or expertise to clear and settle its own trades, the introducing broker-dealer often contracts with a third-party clearing firm to carry it accounts and perform its back office functions on a fully-disclosed basis (i.e., disclosed to the introducing firm's end customers). In fact, approximately 90% of all broker-dealers registered with the SEC utilize fully disclosed clearing firms. According to the SEC Office of Economic Analysis (as of January 31, 2004, the most recent date available), there were a total of 5,218 broker-dealers doing business with the public and registered with the SEC. Of that total, 573 broker-dealers were self-clearing firms -- and 4,645 broker-dealers utilized the services of fully-disclosed clearing firms.

introducing firm and/or its client). (See Proposed Amendments at 2340c(1)(A)(i) & n. 5).

Industry practice has long been that the clearing firm would either rely upon the information provided to it by the issuer (or sponsor) of the unlisted securities, such as DPPs and REITs – which have no public market – or contract with a recognized third party provider of independent valuation services (IVS) to provide estimated valuations.[4]

The Proposed Amendments explicitly allow the clearing firm to continue to rely on an IVS (or any other source) to provide it with estimated valuations – a practice which SIFMA fully supports. SIFMA also agrees that a clearing firm should not post an estimated valuation received from a source if it knows – i.e., has actual knowledge—that the valuation is inaccurate. This is the current standard under Rule 2340 (i.e., the clearing firm can "demonstrate" the inaccuracy).

However, the Proposed Amendments extend well beyond the actual knowledge standard ("if it knows") and appear to impose an additional requirement that the clearing firm also refrain from posting an estimated valuation if it "has reason to know" – based, not just on its own records -- but on publicly available or non-public information that has come to the member's attention – that the price information may be unreliable. SIFMA is concerned that this broader language may impose on clearing firms a new and on-going affirmative duty to monitor and confirm the reliability of the valuations received from the IVS (or other source) for thousands of unlisted DPPs and REITs. The broad language of the Proposed Amendments would in essence require the clearing firm to act as an insurer or guarantor of estimated valuations received from third parties who have far more expertise in providing valuations – or face regulatory exposure and potential civil liability after the fact. Clearing firms handle hundreds of thousands of trades daily on behalf of millions of end customers of introducing firms. If clearing firms were required to continuously monitor the "reliability" of estimated pricing received for millions of introduced accounts to determine if it had "reason to know" of unreliability, then the speed and efficiency demanded in the contemporary securities markets would not be possible.[5] As further explained below, in 2000 the NASD rejected the "has no

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[4] Rule 2340 specifically recognizes that an IVS "is intended to refer to a company, independent of a member, that is in the business of providing estimated values for DPP and REIT securities." See NTM 01-08 at n. 5. There are a handful of industry recognized IVS for DPPs and REITs. Rule 2340 also recognizes that the clearing firm may receive estimated values for DPPs and REITs from the annual report or "any other source" (which may include issuers who may – or may not be—affiliated with the introducing firms). See NTM 01-08

[5] Nothing in this Comment Letter is intended to suggest or imply an avoidance of FINRA guidance on outsourcing activities as set forth in NTM 05-48 and its progeny. Clearing firms recognize that they must have in place specific policies and procedures that will monitor the IVS' compliance with the terms of any agreements and assess the IVS' continued fitness and ability to perform the covered activities being outsourced. The Proposed Amendments however, seek to impose obligations on the clearing firm far beyond this outsourcing guidance, as well as FINRA's current rule proposal on third-party service providers (proposed FINRA Rule 3190).

reason to believe" standard for clearing firms. As set forth below, we believe the "has reason to know" standard should be similarly rejected here.

SIFMA respectfully submits that FINRA should delete the new requirements set forth in items 1-3 above, and should retain the standard of "actual knowledge" under the current version of Rule 2340 which requires that a clearing firm refrain from posting an estimated valuation received from a third party only in those cases where the clearing firm can "demonstrate" the "inaccuracy" of the estimated value.

I. Existing Case Law and Regulations Have Long Recognized the Specialized Role of Clearing Firms

Clearing firms do not sell securities, nor do they exercise investment discretion. Rather, a fully-disclosed clearing firm provides "back office" processing services: clearance and settlement and custody services to other introducing broker-dealers. (See FINRA Rule 4311 (effective August 1, 2011, and consolidating former NYSE Rule 382 and NASD Rule 3230)).

The relationship between the clearing firm and the introducing broker-dealers is set forth in a Fully Disclosed Clearing Agreement ("FDCA"), which is filed with and approved by FINRA. FINRA Rule 4311 *requires* the allocation of certain responsibilities between a clearing firm and introducing firm be set forth in the FDCA and, for practical reasons, other responsibilities for which the rule does not require specific allocation are typically allocated in the FDCA.[6]

Under industry standards, all the customer-facing or "front office" responsibilities are allocated exclusively to the introducing broker-dealer – including account opening, due diligence, suitability and supervision of accounts, account activity, and registered reps. Because the relevant front office duties are formally allocated to the introducing firm and confirmed in a written agreement, which is approved by the regulators, the clearing firm is *relieved* of those duties. (See NYSE Information Memo 82-18 (Mar. 5, 1982)).

Because of the clearing firm's back office role, statutory and common law claims are routinely dismissed under a long-line of precedent holding that, absent red flags, no liability arises from a clearing firm's mere performance of its routine and ministerial clearance functions.[7] It is also black-letter law that a clearing firm owes no fiduciary

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[6] As part of the clearing arrangement, each end customer of the introducing firm receives a disclosure letter (known in the industry as a "Rule 382 letter") at the beginning of the clearing relationship notifying them of the specialized role of the clearing firm and the allocation of duties between the clearing firm and their introducing broker-dealer.

[7] *See, e.g.,* Fezzani v. Bear Stearns & Co., 592 F. Supp. 2d 410 (S.D.N.Y. 2008) (clearing firm not liable for correspondent's misconduct since clearing firm merely cleared the transactions); Greenberg v. Bear, Stearns & Co., 220 F.3d 22 (2d Cir. 2000) (The simple providing of normal

duty to the end customers of the introducing broker-dealer and cannot be held liable for the acts of an introducing firm. See, e.g., McDaniel vs. Bear, Stearns & Co., Inc. and Bear Stearns Securities Corp., 196 F. Supp.2d 343 (SDNY 2002); Rozsa v. May Davis Group, Inc., 187 F. Supp.2d 123 (S.D.N.Y. 2002) (finding that a clearing firm performing ministerial back office functions did not owe a duty to the plaintiff and therefore was not liable to him for his broker's misdeeds), *aff'd*, 2006 U.S. App. LEXIS 2131 (2d Cir. 2006).

As set forth below, the broad language of the Proposed Amendments appears to be inconsistent with these regulations and precedent because they may be applied in a manner that transforms the clearing firm into something it is not -- and could never be – i.e., an insurer, a guarantor or a fiduciary to the end-customers of introducing firms as to the reliability of estimated valuations received from third-party valuation services.

II. NASD Has Previously Recognized that a Clearing Firm Should Not Be Required to Confirm the Reliability of an Estimated Valuation Received from an IVS, an Annual Report (or other source) Under Rule 2340

The current version of NASD Rule 2340 states that a clearing firm may rely on an estimated price for an unlisted DPP or REIT received from an IVS – and explicitly states under a section entitled "Reliability of Estimated Values" that Rule 2340 "does not obligate a general securities member to confirm the accuracy of an estimated value provided in a DPP or REIT's annual report or provided by any other source external to the member." (See NASD NTM 01-08 at 34). The current version of Rule 2340 further states that if the member "can demonstrate (i.e., to the NASD) that the estimated value was inaccurate as of the date of the valuation or is no longer accurate as a result of a material change in the operation or assets of the [DPP or REIT]", the member must "refrain" from including that estimated value on the statement. (See Id.). SIFMA submits that this current standard that requires "actual knowledge" should be retained.

It appears that the inclusion of the words "demonstrate" and "inaccuracy" as found in the current version of Rule 2340 likely resulted from a comment letter received by the SEC during the comment period for amendments to NASD Rule 2340 that were proposed in 2000. In particular, the commenter was concerned then – just as SIFMA is today -- that the proposed rule, as then drafted "would have required members to make an affirmative determination about the reliability of estimated values provided through an annual report of a DPP or REIT, by an independent valuation service, or through any

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clearing services to a primary broker who is acting in violation of the law does not make out a case of aiding and abetting against the clearing broker).

other source." (See Securities Exchange Act Release No. 432601 (November 21, 2000); 65 F.R. 71169 at pp. 4-5 (November 29, 2000)).[8]

Specifically, the commenter asserted that as then drafted, the rule "would impose an unfair obligation on a member to consider the accuracy of an estimated valuation, even if the member had obtained the estimated value from the DPP or REIT's annual report or from an independent valuation service that the member had retained to provide a valuation." The commenter recommended that NASD Regulation amend the rule to include a provision from the 1997 Proposal that would prohibit a member from including on an account statement "an estimated value that the member believes is inaccurate as of the date of the valuation or is no longer accurate as a result of a material change in the operations or assets of the program or trust." The commenter believed that the revised language would prohibit a member from providing an estimated valuation that the member believes is inaccurate -- without imposing an affirmative duty on the member to determine that it has no reason to believe that the estimated value is inaccurate. (See Id., 65 F.R. 71169 at pp. 5-6 (November 29, 2000)).

NASD Regulation responded to the concerns raised by other commenters, by deleting the "no reason to believe" language and adopting the current language of the rule which states that a member may refrain from including a per share estimated value for a DPP or REIT security on an account statement only if the member can "demonstrate" that the value was "inaccurate" as of the date of the valuation or is no longer accurate as a result of a material change in the operations or assets of the program or trust. In so doing, NASD Regulation explicitly stated in 2000 that NASD Rule 2340 "was not intended to impose an obligation on members to guarantee the accuracy of an estimated value obtained from a third party source." (See NASD NTM 01-08). Clearing firms have long relied upon the NASD's statement in the presentation of estimated values to end customers on account statements.

SIFMA respectfully submits that the key words in the current version of Rule 2340 are "demonstrate" and "inaccuracy" -- and that this is the proper objective standard for a clearing firm to follow – i.e., if the clearing firm has actual knowledge such that it can "demonstrate" the "inaccuracy" of the estimated valuation received from a third party, the clearing firm should not post that estimated valuation on an account statement. The current language sets a bright line objective test which is sufficient to encompass both actual knowledge of an inaccurate price as well as red flags which come to the clearing firm's attention suggesting an inaccuracy.

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[8] It is important to note that the draft of the rule which the commenter was commenting on in 2000 provided that a member could use an estimated valuation for a DPP or REIT on an account statement if "after considering any relevant information about the market and the particular investment in its possession, the member *has no reason to believe* that the estimated valuation is inaccurate." Id.. 65 F.R. 71169 at p. 5 n.18 (November 29, 2000) (italics supplied). Thus, the draft of the rule as commented on by the commenters was even narrower than the scope of the Proposed Amendments being considered today.

Under industry practice, if a clearing firm receives red flags that come to its attention as to accuracy of estimated pricing, it generally makes that information available to the IVS and asks the IVS to reconsider the valuation in light of this information. If the IVS changes the valuation in light of the information, then all clearing firms who may use that same IVS will receive the same amended valuation for that CUSIP. And if the IVS retains the same valuation for that CUSIP even after considering the new information brought to its attention, then the clearing firm should be able to reasonably rely on the IVS' expertise in this area and not face regulatory exposure for posting that valuation – unless of course it has "actual knowledge " and can "demonstrate" that the IVS valuation is "inaccurate." Similarly, it is industry practice for clearing firms to convey price challenges to the IVS. Sometimes the IVS will change a price in light of a challenge, and sometimes it will not. If the IVS does not change its valuation in light of the price challenge, the clearing firm should be able to continue to rely on the IVS' expertise in this area and it should not have to change the IVS valuation on its own volition unless it has enough facts and information relating to the security at issue so as to have actual knowledge of the inaccuracy – i.e., where it can "demonstrate" the estimated value received from the IVS is inaccurate. SIFMA agrees that a clearing firm should not post an estimated valuation "if it knows" that the estimated value is inaccurate.

What the NASD recognized in 2000 the last time similar changes to Rule 2340 were proposed remains true today: a clearing firm should not be obligated to guarantee an estimated value that is obtained from a third-party source. However, by imposing a standard in the proposed rule that is based not just on actual knowledge -- but knowledge the member "has reason to know" -- FINRA is codifying an affirmative duty of inquiry upon the clearing firm that is inconsistent with the previously recognized specialized role of the clearing firm and is tantamount to stating that no valuation provided by a third-party source can ever be accepted on its face. In effect, it eliminates any of the efficiencies that arise from using a third-party expert to obtain such valuations. Further, the "reason to know" standard appears to be an even broader standard than the "has no reason to believe the value is inaccurate" standard that was summarily rejected by the NASD back in 2000.

The Proposed Amendments also appear to require clearing firms to affirmatively monitor "public or non-public information" for thousands of DPPs and REITs to determine if there is a "reason to know" of unreliability or face regulatory liability. While there is seemingly qualifying language in the proposal that it is information that "has come to the attention" of the member, the practical reality is that it is not very difficult for anyone – regulator or litigant – to establish that information that was publicly available "came to the attention" of someone employed by a clearing firm or by an affiliate of a clearing firm. And it is difficult, if not impossible, for a person to prove that he or she did not see something when the allegation is that the information was readily available to the general public. "Public information" in the context of a REIT may include something as generic as the current state of the commercial real estate

market. It would not be correct to impose an obligation on the clearing firm to question the valuations presented by a third-party expert in valuations simply because the clearing firm is aware of the general state of the real estate market. This is very different than if the clearing firm has been advised directly of issue concerning the performance of a specific REIT issuer.

Clearing firms custody thousands of different DPPs and REITS and they lack the expertise or the operational resources to be able to confirm the reliability of estimated valuations received from an IVS (who are in the very business of providing such valuations). As the valuations appear on monthly (or, if applicable, quarterly) statements, it would impose an incredible burden on the clearing firm to do this kind of affirmative investigation and monitoring review into thousands of unlisted DPPs and REITS held by end customers prior to transmitting each monthly (or quarterly) account statement. Such a standard would inappropriately shift the burden of providing accurate information to the investor from the issuer of the investment to the clearing firm. It would cause the clearing firm to act as the gatekeeper and guarantor.

Similarly problematic is the requirement that "non-public information" may act as a trigger for the "reason to know" standard. Many clearing firms are part of larger entities that are involved in many different aspects of the securities business. Firms are required to "wall off" the various businesses to prevent the improper communication and use of certain confidential information across those businesses. Yet, as the proposed language uses the phrase "has come to the attention of the member", information that is received on one side of the "wall" may be imputed to the whole member and may be viewed as information the clearing firm (or business of the member) should have considered before publishing prices on an account statement. Not only does this proposal violate the concept of the "Chinese Wall", it could lead to inconsistent results for the same DPP or REIT. Consider the following scenario which will occur under the Proposed Amendments: Clearing Firm A declines to post an estimated value received from an IVS on a DPP or REIT based on nonpublic information that permissibly came to the clearing firm's attention (but which information it cannot disclose to the IVS or other third party because of confidentiality). However, Clearing Firm B -- holding the exact same DPP or REIT for its introducing firms -- continues to post the estimated value received from the same IVS used by Clearing Firm A because Clearing Firm B is not privy to that nonpublic information. The Proposed Amendments will create an inconsistency in account statement disclosures for the exact same security held at two different clearing firms – all depending upon the subjective facts available -- or not -- to a particular clearing firm. [9]

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[9] It should be noted that virtually all non-disclosure agreements often impose restrictions that the recipient may only use such confidential information for a specific and limited purpose. The Proposed Amendments, however, would impose an obligation on clearing firms to use such confidential information lawfully in its possession to evaluate the reliability of an estimated valuation for a DPP or REIT – and to reject such valuation if the clearing firm "should have known" based on the nonpublic information that such valuation was unreliable. Using non-public information in this way may expose the firm to liability for breach of the non-disclosure

Additionally, applying the "reason to know" standard as the basis for requiring clearing firms to remove estimated valuations would appear to directly conflict with the separate IRS standards which require IRA custodians to provide fair market valuations at year end. In this circumstance, the member firm's compliance with FINRA's standard would likely result in the display of one valuation on account statements -- and potentially a different valuation on IRA documentation due to the difference in the IRS' requirements. It appears that the application of the "actual knowledge" standard by FINRA would result in a less conflicting standard on member firms who must also comply with IRS regulations.

In sum, the Proposed Amendments will place the clearing firm in an untenable position: if the clearing firm receives an estimated valuation from an IVS – but becomes concerned that it is unreliable, it can provide the information which may affect the reliability to the IVS and ask the IVS to re-consider its valuation. If the IVS – who has far more expertise than the clearing firm -- says it is retaining the estimated value as is and will make no change, the clearing firm is faced with an impossible choice under the Proposed Amendments. If the clearing firm continues to rely on the IVS' estimate – and that estimate turns out to be "unreliable" after the fact, then the clearing firm will be exposed to liability from FINRA for posting that IVS supplied value and violating the new Rule 2340. But if the clearing firm decides to ignore the IVS supplied value – and the clearing firm's decision turns out to be in error -- the clearing firm may be exposed to potential liability from the issuer of the DPP or REIT, the introducing firm who sold it, and the end customer who bought it for impairing the value of their holdings.[10]

A. Clearing Firms Should Not Be Required To Publish the Reason an Estimated Valuation Does Not Appear in an Account Statement

The Proposed Amendments replace the current language of Rule 2340 which requires disclosure "if applicable, that accurate valuation information is not available" with a more substantive disclosure explaining the "reason why the value does not appear in, or has been removed from, the account statement." (See Proposed Amendments 2340c(3)(iv)). If the reason for removal of the valuation was due to "non-public information" lawfully in the possession of the clearing firm, the Proposed Amendments would require the clearing firm to post that reason on the statement—thereby exposing the clearing firm to potential liability. Compliance with an SRO rule should not expose a clearing firm to civil liability. Similarly, even where public information provides the

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agreement – yet not using the non-public information in that way may expose the firm to regulatory liability from FINRA for not complying with the Proposed Amendments to 2340. SIFMA respectfully submits that this cannot have been FINRA's intent.

[10] Although Rule 2340 only applies to account statements and not IRS required statements, see RN 11-44 at n.2, there may be potential tax consequences to the end customer resulting from the clearing firm not posting an available IVS price on the account statement -- especially if the DPP or REIT is held in a retirement account. Potential tax implications flowing from the Proposed Amendments are beyond the scope of this Comment Letter.

basis for the purported "unreliability" of the estimated valuation, and its removal, the Proposed Amendments require that that specific reason be disclosed on the account statement. A clearing firm should not be required to provide such an explanation to the introducing firm's end customers about products sold by them (especially where a DPP or REIT sponsor is affiliated with the introducing firm). Such a communication is exclusively an introducing firm's obligation allocated to the introducing firm under FINRA Rule 4311. Indeed, such a requirement is unnecessary and inconsistent with industry practice. There are many other kinds of factual circumstances in which a clearing firm is required to remove or does not include a value on an account statement – for example, bankruptcy, illiquid markets, trading halts, unavailability of pricing – and no specific explanation from the clearing firm is required (other than a general disclosure on the statement backer consistent with the current language of Rule 2340).

B. The Proposed Amendments Should Not Apply to DPPs or REITS Prior to the Issuance of an Annual Report or Which are Listed "Below the Line"

Current Rule 2340 states that a member may voluntarily provide a price for a DPP or REIT on an account statement prior to the issuance of an annual report, subject to the requirements of the rule, but must provide a price beginning with the monthly statement that follows the month in which the DPP or REIT has produced an annual report that contains a valuation. The Proposed Amendments would require a member to provide a price from the time the DPP or REIT first is received in the account, which could be from the date the REIT is first offered for sale. With the additional requirements imposed by the rule (even if such requirements are modified consistent with SIFMA's requests in this letter), the pricing of a REIT or DPP on a statement should remain permissive but not mandatory prior to the issuance of an annual report that contains a value. If a member wishes to provide a price in the period prior to the annual report, it may do so as long as the price information is provided consistent with the other requirements of Rule 2340.

The Proposed Amendments as currently drafted also appear to apply the requirements of Rule 2340 to the display of DPPs and REITs that are held "below the line" on account statements – i.e., to those securities for which the clearing firm performs no clearing or custody services – and which are custodied elsewhere. Most clearing firms will accommodate introducing firms by including on the account statement certain securities held "below the line" for informational purposes only with numerous disclaimers. In such instance, the estimated value of that security (if any) held below the line is not included in the total market value shown on the account statement sent by the clearing firm.

The first sentence of the Proposed Amendments states that a clearing firm "that *holds* a [DPP or REIT] *in a customer's account* must provide a per share estimated value …" (See Proposed Amendments 2340(c)(1); italics supplied). The words "hold" and "in a customer's account" means that the clearing firm has possession and control and thus the security is held "above the line" – included in total account value on the account

statement because it is custodied by the clearing firm. Thus, the statutory language itself appears to limit the Proposed Amendments to only those DPPs and REITs held above the line.

However, footnote 5 of RN 11-44 also says that the Proposed Amendments will apply to DPPs and REITs "regardless of whether they are listed or itemized 'above the line' or 'below the line.'" SIFMA submits that such an extension of Rule 2340 to below the line securities is overbroad and unworkable.[11]

If the clearing firm does not have possession or control of the DPP or REIT (which is custodied elsewhere), the clearing firm does not have SEC Rule 15c3-3 (customer protection) obligations for those holdings (nor will there be SIPC coverage for below the line securities). In cases where the clearing firm is not responsible for possession or control, in other words, where it does not "hold" the security, it should not be required to ensure the reliability of valuations noted for such a security – and where those securities are not even included in total account value. SIFMA submits that Rule 2340 should only apply to securities held above the line – i.e., those securities in the possession and control of the clearing firm and for which the clearing firm provides clearing or custody services. (FINRA has separately addressed its expectations regarding "below the line" – or "assets held away" – securities in Regulatory Notice 10- 19.)

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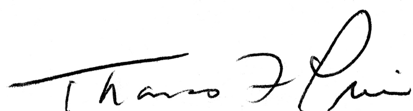
SIFMA appreciates the opportunity to comment on the Proposed Amendments. Our comments above are intended to reflect industry practice, and to foster consistency between the Proposed Amendments and the regulatory guidance and well-established body of case law long governing the clearing industry. SIFMA would welcome the opportunity to discuss these comments with FINRA. If you have any questions, please reach out to me at (212) 313-1260.

Sincerely,



Thomas F. Price
Managing Director

cc: Financial Industry Regulatory Authority, Inc
Marc Menchel, Executive Vice President and General Counsel for Regulation

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[11] There is no indication in any of the past guidance on Rule 2340 that FINRA intended to apply Rule 2340 to below the line securities. The current version of Rule 2340 appears to have limited its application to above the line securities by defining "account activity" to involve "securities or funds in possession or control of the member." See NASD Rule 2340(d)(1)

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